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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. [redacted] 196

FRUEHAUF CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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No.

FRUEHAUF CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner, Fruehauf Corporation, prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court (R. 96a-140a) is reported at 42 T.C. 83. The opinion of the Court of Appeals (Appendix A, *infra*, pp. 1a-8a) is reported at 356 F. 2d 975.

JURISDICTION

The judgment of the Court of Appeals was entered March 10, 1966 (Appendix A, *infra*, p. 9a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

This case involves petitioner's Federal income taxes for the years 1954, 1955 and 1956. The Commissioner of Internal Revenue, in 1950, determined that petitioner must inventory its used trailers on the $1 per unit method. In 1959 the Commissioner decided that petitioner must change to the lower of cost or market value method of inventorying such trailers, making such determination retroactive to 1954 and subsequent years. Both the Tax Court and the Court of Appeals held that the Commissioner's 1950 decision was a mistake of law, and hence could be reversed retroactively. The questions presented are:

1. Whether the Commissioner may retroactively reverse his decision requiring a taxpayer to use a particular method of accounting, where such ruling did not constitute a mistake of law.

2. Whether the discretion given the Commissioner by Section 41 of the Internal Revenue Code of 1939 (corresponding to Section 446(a) and (b) of the 1954 Code), to require a taxpayer to use a method of accounting which clearly reflects income, is broad enough to authorize him to require a taxpayer to use an erroneous inventory method in order to protect the revenue, so that such exercise of his discretion is not a mistake of law.

STATUTES AND REGULATIONS INVOLVED

Sections 22(c) and 41 of the Internal Revenue Code of 1939, and the pertinent provisions of the regulations issued thereunder are set forth in Appendix B, *infra*, pp. 10a-14a.

STATEMENT

The petitioner, since its organization, has been primarily engaged in the business of manufacturing commercial truck-trailers. It began acquiring used trailers about 1926, and adopted the practice of inventorying them at $1 per unit. (R. 101a, 103a) Although its returns were examined and audited by the Internal Revenue Service, this practice was not changed for years prior to 1942. In 1948, the petitioner received a revenue agent's report for the years 1942 through 1945, in which the agent proposed to change the closing 1945 used trailer inventory to the lower of cost or market value method. The petitioner protested this change, contending that if the change were made as of December 31, 1945, similar adjustments should be made in opening and closing inventory for the four years 1942 through 1945. At a conference in the office of the Internal Revenue Agent in Charge in Detroit in September, 1948, a tentative agreement was reached to change the used trailer inventories for the four years in question to the lower of cost or market value method. (R. 104a) On November 9, 1948, the petitioner executed a Form 874 agreeing to deficiencies for such four years computed in accordance with the agreement, and on February 11, 1949, it was notified by the Detroit office that the case would be disposed of in accordance with the agreement evidenced by Form 874. (R. 105a)

As of January 1, 1949, partly because petitioner thought the inventory issue was settled, in accordance with the Form 874, and partly in the interest of more accurate reporting of annual earnings, petitioner changed, on its books, its method of inventorying used trailers to the lower of cost or market value method. (R. 106a)

It was necessary for the agreement evidenced by the Form 874 to be approved by the National Office of the Internal Revenue Service, since the allowance of certain claims for relief under Section 722 of the 1939 Code resulted in over-assessments which were required to be reported to the Joint Committee on Internal Revenue Taxation of Congress (Section 3777, 1939 Code). In the course of the preparation of their report, representatives of the Chief Counsel of the Internal Revenue Service questioned the propriety of the change in used trailer inventory method, since such change would result in a double deduction, that is, the amount of the opening 1942 inventory would escape tax. (R. 107a-109a) A memorandum from the Chief Counsel's office to the Income Tax Unit stated:

> "While taxpayer's method of computing inventories of used trailers is obviously erroneous, it is the opinion of this office that a correction should not be made in this case in a manner that will result in the substantial benefit to the taxpayer as now proposed. * * * Unless a settlement on a more equitable basis can be reached or the correction made starting in a year where the opening inventory is small and the double benefit would not be so great (as, for instance, the year 1944), it is the opinion of this office that the Government should refuse to permit a change in the erroneous method of inventorying used trailers used by the taxpayer." (R. 109a, 110a)

After several conferences between representatives of the petitioner and the Internal Revenue Service, the Chief Conferee of the Detroit office advised petitioner on June 23, 1950, that it had been decided to restore petitioner's used trailer inventory to the $1 per unit method. On July 5, 1950, a revised Form 874, recomputing income for the years 1942-1945 by the use of the $1 per unit method, was executed. Petitioner's taxes for said years were finally determined in accordance with said Form 874, after the Commissioner had signed and filed his report with the Joint Committee on Internal Revenue Taxation. (R. 111a, 112a)

In the meantime, after the tentative agreement of September 10, 1948, but before June 23, 1950, petitioner filed a claim for refund for 1946, an amended return for 1947, and an original return for 1948, all based on the inventorying of used trailers at the lower of cost or market value method. The Commissioner rejected the 1946 claim for refund, and the amended 1947 return, and recomputed the 1948 return by inventorying used trailers on the $1 per unit method. Such action was taken in conformity with the determination of taxes for the years 1942-1945 as reflected in the Form 874 dated July 5, 1950. For 1949 and subsequent years, petitioner's income tax returns were filed on the basis of inventorying used trailers on the $1 per unit method. The returns for the years 1949 through 1953 were examined by a revenue agent and, while the $1 per unit method was questioned, it was not disturbed. However, on March 31, 1959, the revenue agent informed petitioner that the National Office of the Internal Revenue Service had decided to reverse its previous decision with respect to used trailer inventories, commencing with the year 1954, and thereafter

the deficiency notices which form the basis for this proceeding were issued. (R. 113a, 114a)

In the Tax Court petitioner contended (1) that the Commissioner was estopped to reverse his 1950 decision requiring petitioner to use the $1 per unit method of inventorying used trailers, or (2) in the alternative, he was precluded from reversing that decision retroactively, that is, in any year prior to 1959. In the Court of Appeals only the latter contention was urged. (Appendix A, *infra*, p. 5a)

Both the Tax Court and Court of Appeals held that the Commissioner's action in 1950, requiring petitioner to use the $1 per unit method, constituted a mistake of law, and hence, under the decisions of this Court, he could reverse such ruling retroactively.

REASONS FOR GRANTING THE WRIT

I. The Holding of the Court Below That the 1950 Decision of the Commissioner Was a Mistake of Law is in Conflict With Decisions of the Courts of Appeals for the Second and Third Circuits and of the Court of Claims, as Well as With the Intendment and Rationale of Decisions of This Court

Whether or not the 1950 decision of the Commissioner could be reversed in 1959, with retroactive effect to 1954, depends upon whether such 1950 decision was or was not a mistake of law. It is well settled that if such decision did constitute a mistake of law the Commissioner has the power to reverse his decision retroactively. For example, the Court of Appeals for the Sixth Circuit held in *H.S.D. Co.* v. *Kavanagh*, 191 F. 2d 831 (6th Cir. 1951), and *Woodworth* v. *Kales*, 26 F. 2d 178, (6th Cir. 1928), that under the circumstances of those cases the Commissioner could not re-

verse his prior rulings.* Those cases were relied on by the petitioner in *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180 (1957), but this Court distinguished them, saying (p. 184):

> "Petitioner's reliance on *H.S.D. Co.* v. *Kavanagh,* 191 F. 2d 831, and *Woodworth* v. *Kales,* 26 F. 2d 178, is misplaced because those cases did not involve correction of an erroneous ruling of law."

This Court again expressed the same position in its decision in *Dixon* v. *United States,* 381 U.S. 68 (1965), where it was stated (p. 72):

> "In *Automobile Club of Michigan* v. *Commissioner, supra,* at 183-184, we held that the Commissioner is empowered retroactively to correct mistakes of law in the application of the tax laws to particular transactions."

The clear corollary of the holding in these cases is that the Commissioner does not have power to reverse retroactively a ruling that does not constitute a mistake of law. This is a succinct statement of petitioner's position in this case.

In another field, this Court has held that an administative agency may not retroactively reverse an exercise of broad discretionary power. In *Arizona Grocery Co.* v. *A.T.&S. F. Ry. Co.,* 284 U.S. 370 (1932), the Interstate Commerce Commission in 1921 had determined a certain rate. In 1925 it attempted to make a new rate, with retroactive application. The Court held that it was beyond the Commission's power to change its 1921 decision retroactively, and that its 1925 decision could

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* While the petitioner relied strongly on *H.S.D. Co.* v. *Kavanagh* below, the Court of Appeals (Appendix A, *infra,* p. 8a) summarily dismissed this decision as being decided on particular facts.

be applied only prospectively. In its opinion, this Court said (p. 390):

> "Where the Commission has, upon complaint and after hearing, declared what is the maximum reasonable rate to be charged by a carrier, it may not at a later time, and upon the same or additional evidence as to the fact situation existing when its previous order was promulgated, by declaring its own finding as to reasonableness erroneous, subject a carrier which conformed thereto to the payment of reparation measured by what the Commission now holds it should have decided in the earlier proceeding to be a reasonable rate."

By statute, the Interstate Commerce Commission is given broad power to fix rates. That power is comparable to the wide discretion (hereinafter discussed) given the Commissioner of Internal Revenue in the accounting method area. In either case, the exercise of that power is not an interpretation of a statutory provision, so as to constitute a mistake of law if erroneous; rather it is the exercise of a discretion entrusted by Congress. In the case of Section 41 of the 1939 Code, Congress provided that a taxpayer's accounting method must be such "as in the opinion of the Commissioner does clearly reflect the income." Such discretion is fully as broad as that given the Interstate Commerce Commission to prescribe rates, and a ruling made pursuant thereto should be as immune from retroactive reversal as was the ruling of the Commission in the *Arizona Grocery* case.

The Commissioner in 1950, required petitioner to inventory its used trailers on the $1 per unit method, even though such method was "obviously erroneous", because a change to the lower of cost or market value

method would result in a "substantial benefit to the taxpayer," i.e., it would have permitted a substantial amount to be twice deducted.

The Tax Court held, and the Court of Appeals affirmed, that the Commissioner went beyond his power in requiring, or permitting, the petitioner to use an incorrect method of accounting, even though such action was taken in order to avert a double deduction; and that such action constituted a mistake of law. This holding is contrary to decisions in the Second and Third Circuits, and in the Court of Claims.

In *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225 (3rd Cir. 1961), the taxpayer changed its method of accounting from an erroneous, to a correct, method. The Commissioner refused to recognize this change, contending that no change of accounting method could be made without his consent. The Tax Court held that the taxpayer's action was proper and that the change was not one in accounting method but merely the correction of an error. The Court of Appeals for the Third Circuit reversed, holding that the change was one in accounting method, and that it was invalid without the Commissioner's consent. It said:

> "The rationale of the Regulation here involved is that virtually any material change in the method of reporting income or deduction items will result in a distortion of taxable income, and it is the Commissioner's responsibility to insure that the distortion will not be to the detriment of the Government. The Commissioner accomplishes this by withholding his consent until the taxpayer agrees to adjustments that will prevent, *inter alia*, duplication of deduction items or omission of income items as a result of the change. (p. 230)

* * * * *

"It is not dispositive that taxpayer's former consistent method of reporting the insurance dividends in the instant case was not correct under the accrual accounting system since it could not be changed without the Commissioner's prior consent." (p. 231)

* * * * *

"The 'broad discretion' of the Commissioner in determining whether to consent to a change was settled in *Brown* v. *Helvering,* 1934, 291 U.S. 193, 54 S. Ct. 356, 78 L. Ed. 725. See also *Commissioner of Internal Revenue* v. *Hansen,* 1959, 360 U.S. 446, 467, 79 S. Ct. 1270, 3 L. Ed. 2d 1360." (p. 231)

A similar set of facts was before the Court of Appeals for the Second Circuit in *American Can Co.* v. *Commissioner,* 317 F. 2d 604 (1963). There that Court also reversed the Tax Court and held that a change from an erroneous to a correct accounting method could be made only with the Commissioner's consent, and under such conditions as the Commissioner might see fit to impose. In the course of its opinion, it said (p. 606):

"A change in accounting method will almost certainly result in some distortion of taxable income, and the Commissioner must insure that such distortion is not overly detrimental to the government."

In *In re Sperling's Estate,* 341 F. 2d 201 (2d Cir. 1965), the Court said:

"The question presented is whether the petitioner can successfully oppose the Commissioner's determination simply by pointing out that the Commissioner has worked within the framework of the taxpayer's own, improper accounting system." (p. 204)

In other words, the Court was called on to decide whether the Commissioner's discretion was broad enough to countenance a taxpayer's erroneous accounting method, or whether he had a duty to require a change to a proper method. The Court held that the Commissioner did not have to change the taxpayer's erroneous method, saying:

> "Of course, it is possible that the taxpayer's accounting system may be so inadequate that the Commissioner has no choice but to redetermine the liability on the basis of his own system; this apparently was the case in *Elmer D. Willis, supra.* But where the taxpayer does have a rational, though improper, system, we think that the Commissioner may choose to let it stand and to pursue only specific deficiencies within it." (p. 204)

In *John Wanamaker Philadelphia, Inc.* v. *United States,* F. 2d , decided by the Court of Claims on April 15, 1966, the taxpayer sought to increase its opening inventory by excluding therefrom the amount of a reserve for future markdowns, the use of such a reserve being contrary to the regulations. The Government contended that the income of the taxpayer would not be clearly reflected if the reserve (which the taxpayer had used for many years) were eliminated. In rejecting the taxpayer's argument and in permitting the government to take a position which violated its own regulations, the Court of Claims stated:

> "Part of the argument is that the opening, but not the closing, inventory was reduced by a reserve for future markdowns, which was an illegal reduction under sections 29.22(c)-2 and (c)-8 of Treasury Regulations 111. The theory is that income cannot be clearly reflected if the accounting method violates the law. The weight of authority

is strongly against this argument. There are many cases in which taxpayers have attempted to right a previous accounting error by changing the method. Where the advantage runs solely to the taxpayer via a double deduction or an exclusion of an income item, the courts have said that the prior method, *though illegal,* was consistent and the changes must be accompanied by an adjustment—presumably to clearly reflect income. *Hackensack Water Co.* v. *United States, supra; Wright Contracting Co.* v. *Commissioner, supra; Broida, Stone & Thomas, Inc.* v. *United States, supra; Commissioner* v. *O. Liquidating Corp., supra.*" (Emphasis supplied)

Thus, both the Second and Third Circuits and the Court of Claims have held that the Commissioner is not obligated to change or permit a taxpayer to change a taxpayer's method of accounting even where such method is erroneous. As a consequence, he commits no mistake of law in failing or refusing to make such change.

In the instant case, the Commissioner, in 1950, required the petitioner to use the $1 per unit method, a method of accounting characterized by the Tax Court and the Court of Appeals as "erroneous", and refused to change the petitioner's method of inventorying used trailers to the lower of cost or market value method, to insure that income would not be distorted as the result of a double deduction. In each of the cases cited above, namely, *O. Liquidating Corp. American Can, Sperling,* and *Wanamaker Philadelphia,* and in the instant case, the continuance of the erroneous method of accounting operated to the benefit of the revenue.

The Commissioner not only was acting within the scope of his power, but was carrying out what the

Second Circuit considered a positive duty. The holding of the Courts below in the instant case, that the Commissioner's failure to change petitioner's used trailer inventory method constituted a mistake of law, is in clear conflict with the decisions of the Second Circuit in the *American Can* and *Sperling* cases, the Third Circuit in *O. Liquidating Corp.*, and the Court of Claims in *Wanamaker Philadelphia*.

The decisions below in the instant case are likewise in conflict with the decision of this Court in *Dobson* v. *Commissioner*, 320 U.S. 489 (1943). There the taxpayer, in 1930 and 1931, sold 200 shares of stock out of 300 which he had purchased in 1929. Later he filed suit against the seller, alleging fraud, and in 1939 recovered a substantial sum, no part of which he reported as income in his 1939 return. The Commissioner audited that return and included as income that portion of the recovery which was allocable to the shares which had been sold. The Board of Tax Appeals held that no part of the amount recovered was taxable. The Circuit Court of Appeals reversed.

At that time, the statute authorizing review by the Circuit Courts of Appeals of decisions of the Board of Tax Appeals (Sec. 1003, Revenue Act of 1926) provided:

> "(b) Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require."

This Court held that the Circuit Court of Appeals had no jurisdiction to disturb the decision of the Board

(the name of which had in the meantime been changed to the Tax Court); since such a decision could be modified or reversed only if the Board had made an error of law, and that no mistake of law had been made. In the course of his opinion Mr. Justice Jackson said (p. 499):

> "But conflicts are multiplied by treating as questions of law what really are disputes over proper accounting."
>
> * * * * *
>
> (p. 504) "What, in the circumstance of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine."
>
> * * * * *
>
> (p. 506-7) "The error of the court below consisted of treating as a rule of law what we think is only a question of proper tax accounting."

In the instant case the decision which the Commissioner made in 1950, to require the petitioner to inventory used trailers on the $1 per unit method, was one involving methods of accounting. It was so held by the Tax Court, which said (R. 129a) "We think petitioner's practice of inventorying used trailers at $1 each was a 'method of accounting.'"

If a decision of the Tax Court as to proper accounting is not one involving a question of law, then similarly a decision or ruling by the Commissioner regarding a method of accounting to be used by a taxpayer does not involve a question of law, and the Commissioner's determination to require a taxpayer to use a particular accounting method, even though such method is erroneous, cannot be a mistake of law. This is particularly true where the Commissioner, in the

exercise of his broad discretion in the accounting area, protects the revenue by preventing a distortion which would be detrimental to the Government. In holding that the Commissioner's 1950 decision requiring petitioner to use the $1 per unit method of inventorying used trailers was a mistake of law, the decision below ran counter to the decision of this Court in the *Dobson* case.

II. The Decision Below Involves an Important Question of Federal Tax Law Upon Which This Court Has Not Ruled Directly, But Which Should be Settled by a Decision of This Court

This Court has stated in several decisions that the Commissioner is given very broad discretion by Section 41 of the 1939 Code and Section 446(b), the corresponding provision of the 1954 Code, in determining the method of accounting to be used by a taxpayer.

In *Lucas* v. *American Code Co.*, 280 U.S. 445, 449 (1930), this Court said:

> "And the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful."

And in *Brown* v. *Helvering*, 291 U.S. 193, 203 (1934), the Court stated:

> "Moreover, the method employed by the taxpayer is never conclusive. If in the opinion of the Commissioner it does not clearly reflect the

income, 'the computation shall be made upon such basis and in such manner,' as will, in his opinion, do so. *United States* v. *Anderson,* 269 U.S. 422, 439; *Lucas* v. *American Code Co.,* 280 U.S. 445, 449; *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115, 120; compare *Williamsport Wire Rope Co.* v. *United States,* 277 U.S. 551; *Lucas* v. *Structural Steel Co.,* 281 U.S. 264. In assessing the deficiencies, the Commissioner required in effect that the taxpayer continue to follow the method of accounting which had been in use prior to the change made in 1923. To so require was within his administrative discretion; compare *Bent* v. *Commissioner,* 56 F. (2d) 99."

More recently, the Court, in *Commissioner* v. *Hansen,* 360 U.S. 446, 467 (1959), said:

"The Commissioner had broad powers in determining whether accounting methods used by a taxpayer clearly reflect income, *Lucas* v. *American Code Co.,* 280 U.S. 445, 449; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 189-190, and under § 41 * * * the Commissioner, believing that the accounting method employed by a taxpayer 'does not clearly reflect the income,' may require that 'computation shall be made in accordance with such method as in [his] opinion . . . does clearly reflect the income.'"

The most recent discussion by this Court of the broad discretion given the Commissioner over methods of accounting was in the opinion of Mr. Justice Stewart in *United States* v. *Catto,* No. 535, October Term, 1965, 86 S. Ct. 1311, 1318, where it was said:

"Congress has granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers, and the uniform application of the unit-livestock-price method to the respondents' entire livestock operation is a reasonable

> exercise of the discretion rested by Congress in the Secretary and the Commissioner for the administration of the tax laws. 'It is not the province of the court to weigh and determine the relative merits of systems of accounting.' *Brown* v. *Helvering,* 291 U.S. 193, 204-205; *Lucas* v. *American Code Co.,* 280 U.S. 445, 449; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 189-190; *Commissioner* v. *Hansen,* 360 U.S. 446, 467; *Schlude* v. *Commissioner,* 372 U.S. 128, 133-135."

While frequently enunciating the general rule as to the Commissioner's wide discretion in the accounting field, this Court has never decided the question of whether the Commissioner's discretion is broad enough to permit him to require a taxpayer to continue the use of a particular accounting method, where such method is erroneous, in order to prevent a distortion of income which would result in a tax detriment to the Government. The number of disputes which may arise in the field of tax accounting is virtually unlimited. The statement which Mr. Justice Jackson made over twenty years ago in the *Dobson* case, *supra,* is no less true today. He said (p. 499):

> "The mere number of such questions [disputes over proper accounting] and the mass of decisions they call forth become a menace to the certainty and good administration of the law."

The decision below casts doubt on the extent to which the Commissioner's discretion in the accounting area goes, a doubt which is not shared by the Courts of Appeals for the Second and Third Circuits or by the Court of Claims. The extent of the Commissioner's discretion in the accounting area is a recurring question, affecting numerous taxpayers, and

all doubt as to the authority of the Commissioner to require a taxpayer to use a method of accounting which is erroneous, where to permit the use of a correct method would result in a double deduction and a detriment to the revenue, should be resolved by this Court.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 16335

FRUEHAUF CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition for Review of a Decision of the Tax Court.

Decided March 10, 1966.

Before: PHILLIPS, Circuit Judge, CECIL, Senior Circuit Judge, and KENT, District Judge.

CECIL, Senior Circuit Judge. The sole question presented on this petition for review of a decision of the Tax Court is whether an order of the Commissioner, changing the petitioner's method of inventorying used trailers, made in 1959, can be retroactive to the petitioner's tax years 1954, 1955 and 1956. The Tax Court decided the issue adversely to the petitioner.

The facts are fully stated in the Findings of Facts and Opinion of the Tax Court. 42 T.C. 83. The pertinent facts are not in dispute. We restate here only such facts as demonstrate the question involved. The petitioner, Fruehauf Trailer Company, began acquiring used trailers about the year 1926. These used trailers were inventoried by the petitioner at one dollar per unit. This practice was not questioned by the Commissioner for the years prior to 1942. The Internal Revenue Service had examined and audited the petitioner's federal income tax returns for the years prior to 1942, and had made no change with respect to the method of inventorying used trailers. The method was questioned in the examination of the 1939 return but nothing was done about it.

On April 28, 1948, the petitioner received the revenue agent's report of March 15, 1948, for the four years 1942 through 1945. In this report the agent proposed to adjust the used-trailer inventory at December 31, 1945, from one dollar per unit to the lower of cost or market. The petitioner protested this change. It was argued on behalf of the petitioner that the one dollar per unit should be continued, but that if the change was made for December 31, 1945, similar adjustments should be made for the opening and closing inventories for the four years 1942 through 1945. At a conference at the Detroit office of the Internal Revenue agent, in September 1948, a tentative agreement was made to revise the inventories for the four years in question, on the lower of cost or market method.

The petitioner executed a Form 874 on November 9, 1948, agreeing to the deficiency for the four years in question. On February 11, 1949, petitioner was notified by the Detroit office that the case would be disposed of in accordance with the agreement evidenced by Form 874. The petitioner paid the assessment on June 8, 1949. The Commissioner never certified the over-assessments as set forth on Form 874.

As of January 1, 1949, partly because petitioner thought the inventory issue was settled, in accordance with Form 874, and partly in the interest of more accurate reporting of annual earnings, petitioner changed, on its books, its method of inventorying used trailers to the lower of cost or market.

It was necessary that the agreement of November 9, 1948, as evidenced by Form 874, be approved by the national office of the Internal Revenue Service. On March 7, 1950, the office of the Chief Counsel returned to the Income Tax Unit in Washington the administrative file for the years 1940 through 1945, for reconsideration of the proposed revision of the used-trailer inventory. The 1940 and 1941 years came under consideration by reason of an allowance of petitioner's claims in part by the Excess Profits

Tax Council. It was stated in the memorandum of the Chief Counsel's office, that,

> "While taxpayer's method of computing inventories of used trailers is obviously erroneous, it is the opinion of this office that a correction should not be made in this case in a manner that will result in the substantial benefit to the taxpayers as now proposed. * * * Unless a settlement on a more equitable basis can be reached or the correction made starting in a year where the opening inventory is small and the double benefit would not be so great (as, for instance, the year 1944), it is the opinion of this office that the Government should refuse to permit a change in the erroneous method of inventorying used trailers used by the taxpayer."

Negotiations between representatives of the petitioner and representatives of the Detroit office and the national office of Internal Revenue Service failed to reach any agreement for the settlement of the inventory issue.

On June 20, 1950, the Deputy Commissioner of Internal Revenue addressed a letter to the internal revenue agent in charge in Detroit which stated in part:

> "The taxpayer's representatives have not made an acceptable offer whereby the double deduction created by the opening inventory for 1942, could be compensated on an equitable basis, but have indicated that recomputation of the inventories on the dollar value basis, heretofore consistently followed by the taxpayer, would be satisfactory."

Following this, on June 23, 1950, the chief conferee of the Detroit office advised a representative of the petitioner that it had been decided to accept petitioner's used-trailer inventory of one dollar per unit. It was then agreed that recomputations would be made for the years 1940 through

1945 on the basis of one dollar per unit inventory. A revised form 874 was executed to this effect on July 5, 1950, and on July 7, 1950, the petitioner was advised through the Detroit office that the case would be disposed of in accordance with the recomputation. On November 15, 1950, petitioner received a refund of $1,503,230.81 in federal income and excess profits taxes (including interest) for the years 1940 through 1945, in accordance with the recomputations agreed to in Form 874 dated July 5, 1950. This restored the petitioner to the dollar per unit method of inventory.

In the meantime, after the tentative agreement of September 10, 1948, but before June 20, 1950, petitioner filed a claim for refund for 1946, an amended return for 1947, and an original return for 1948, all based on the inventorying of used trailers at the lower of cost or market. The Commissioner rejected the claim for refund on the 1946 return on January 28, 1953. He rejected the amended return for 1947, and the 1948 return was recomputed on the basis of inventorying used trailers at one dollar per unit. This action was taken in accordance with the agreement reflected in Form 874, dated July 5, 1950. In 1949 and thereafter, the petitioner filed its returns with its inventory of used trailers at one dollar per unit. The petitioner's returns for the years 1949 through 1953 were examined by a revenue agent and, while the one dollar per unit practice was questioned, it was not disturbed.

> "On March 31, 1959, the revenue agent informed petitioner that the national office of the Internal Revenue Service had decided that it could no longer go along with petitioner's practice of inventorying its used trailers and that, beginning with the trailers acquired during 1954 the inventory would have to be computed on the lower of cost or market basis. Thereafter, on April 28, 1960, and August 29, 1960, the deficiency notices which form the basis for this proceeding

were issued." Findings of Fact, Tax Court. 42 T.C. 83, 94.

In this Court, it is conceded that the Commissioner could make the change prospectively, in the method of reporting the petitioner's inventory of used trailers. It is argued that the change cannot be made retroactive to the years 1954, 1955 and 1956.

The petitioner, on the issue now before us, argued in the Tax Court that it was an abuse of discretion on the part of the Commissioner to apply the order of March 1959, changing the method of inventory, retroactively. The Tax Court decided against the petitioner on the question of abuse of discretion. It found that "Respondent was not precluded in 1959 from making the change beginning with the then open years 1954, 1955 and 1956." The claim of abuse of discretion is abandoned and is not presented to our Court on this review.

It is now claimed that the decision of the Commissioner, in 1950, to continue the petitioner's one dollar per unit method of inventorying used trailers, had the force of legislation and could not be applied retroactively. In support of this claim, it is argued that the Commissioner is given a broad discretion under Section 446(a) and (b) Title 26, U.S.C., to make a computation of income which, in his opinion, clearly reflects income, that his exercise of that discretion in 1950 was legislative in nature and that the Commissioner could not subsequently retroactively reverse legislative action.

We cannot accept the theory that the Commissioner's decision in 1950 to permit the petitioner to continue a method of inventorying used trailers which was obviously erroneous was legislative in character.

As said by the Supreme Court in *Dixon* v. *United States*, 381 U.S. 68, 72:

> In *Automobile Club of Michigan* v. *Commissioner*, *supra*, 183-184, we held that the Commissioner is empowered retroactively to correct mistakes of law in the application of the tax laws to particular transactions. He may do so even where a taxpayer may have relied to his detriment on the Commissioner's mistake. See *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129. This principle is no more than a reflection of the fact that Congress, not the Commissioner, prescribes the tax laws. The Commissioner's rulings have only such force as Congress chooses to give them, and Congress has not given them the force of law. Consequently it would appear that the Commissioner's acquiescence in an erroneous decision, published as a ruling, cannot in and of itself bar the United States from collecting a tax otherwise lawfully due."

The principal authority cited in support of petitioner's theory is *Arizona Grocery* v. *Atchison Ry.*, 284 U.S. 370. In this case there was an order of the Interstate Commerce Commission fixing freight rates in accordance with the statute[1] giving it the power to fix rates. It was a general order affecting all railroads operating between the points involved. Later, after the Commission found that the rate was unreasonable, it fixed a new lower rate and made it retroactive. The Court held that the Commission could make the new rate applicable to the future but could not make it retroactive. This is not analogous to the case before us.

It is not necessary in this opinion to engage in a discussion of so-called "legislative rules" and "interpretative rules" or the distinction between these terms. As to this distinction, Professor Davis in his *Administrative Law Treatise*, Vol. 1, § 5.03, p. 298 (1958), says:

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[1] Sec. 418-421, 41 Stat. 484-488.

> "Yet we have the benefit of only occasional judicial explanation of the distinction, and the Supreme Court apparently has never provided a full-bodied discussion of it. Indeed, the term 'legislative rule' or 'legislative regulation' apparently does not appear in any Supreme Court opinion."

In the case before us we have a decision of the Commissioner affecting the inventory of one individual company. The decision does not involve a change in the law nor any change in the regulations. The Commissioner has simply interpreted existing law by correcting an erroneous method in the taxpayer's practice of inventorying used trailers.

In this connection the Tax Court said:

> "It was a mistake of law for the respondent to permit petitioner to continue to inventory its used trailers at $1 each after about 1942 when both petitioner and respondent were satisfied that is was obviously erroneous to pursue such a practice, because such practice was contrary to the respondent's regulations. See Regulations 111, section 29.22(c)-2, and Regulations 118, section 39.22(c)-2, both of which provide that 'Taking * * * the inventory, at a nominal price or at less than its proper value' was not in accord with the regulations. See also *Dobson* v. *Commissioner*, 320 U.S. 489, wherein the Supreme Court has held it to be 'a clear-cut question of law' where 'applicable statutes and regulations properly interpreted forbid' a method of calculation, such as the taking of inventories in the instant case at the nominal price of $1 per unit."

Counsel for the petitioner have based their claim for reversal of the decision of the Tax Court squarely on the theory that the 1950 decision of the Commissioner was legislative in character and that it cannot be reversed retroactively. Not one authority, analogous to the case at bar, has been cited to us, nor have we found any that

supports this theory. Cases,[2] other than those decided on the legislative theory, are cited where the Commissioner was not permitted to change a former ruling or to apply it retroactively but those cases were decided on the particular facts of each case.

Throughout the argument of counsel for the Commissioner the tax years in question, 1954-1956, are referred to as open years, that is, assessment for those years is not barred by the statute of limitations. No explanation is given as to what statute is involved or how it is applicable to the facts of this case. We presume the statute is Section 6501(e)(1)(A), Title 26, U.S.C. Neither the petitioner nor the Tax Court raise any question about the years under consideration being barred by the statute of limitations, so we treat them as open years as claimed by the Commissioner.

Since the only claim of the petitioner, based on the legislative theory fails, we must conclude that the finding and decision of the Tax Court is correct. The Tax Court found that "Respondent was not precluded from making the change beginning with the open years 1954, 1955 and 1956," and that he was not estopped from doing so by his prior actions.

The Internal Revenue Code of 1954 provides that "The Secretray or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect." 26 U.S.C. § 7805(b). The Tax Court held that the Commissioner did not abuse his discretion in his retroactive ruling in the present case.

Finding no error of law in the decision of the Tax Court, it is affirmed.

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[2] *Maloney* v. *Hammond*, 176 F. 2d 780, C.A. 9; *H. S. D. Co.* v. *Kavanagh*, 191 F. 2d 831, C.A. 6; *Woodworth* v. *Kales*, 26 F. 2d 178, C.A. 6.

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 16335

FRUEHAUF CORPORATION, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Before: PHILLIPS, Circuit Judge, CECIL, Senior Circuit Judge, and KENT, District Judge.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

No costs awarded. Rule 23(4).

Entered by order of the Court.

CARL W. REUSS
Clerk

(Filed Mar. 10, 1966, Clark W. Reuss, Clerk)

APPENDIX B

Internal Revenue Code of 1939:

Sec. 22. GROSS INCOME.

* * * * * * * * * * *

(c) INVENTORIES.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

For use of inventories, see section 22(c).

Treasury Regulations 111 on Income Tax (1939 Code):

§ 29.22 (c)-1 Need of inventories.—

In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary

in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 29.22(d)-1.)

§ 29.22 (c)-2 Valuation of inventories.—

Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to

be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

* * * * * * * * * * *

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

* * * * * * * * * * *

§ 29.41-1 Computation of net income.—

Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's

income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

§ 29.41-2. Bases of computation and changes in accounting methods

Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 29.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 29.22 (c)-5.)

* * * * * * * * * *

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 29.22(c)-1 to 29.22(c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 29.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 29.22(a)-7 and 29.23(a)-11). * * * Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. * * *

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prohibited by the longstanding Treasury Regulations.[2] Petitioner now concedes that it should not have taken a deduction for the costs incurred in acquiring and reconditioning the trailers but should have, in general, added such costs to inventory and thus deferred such deductions until the reconditioned trailers were sold (R. 90a; Supp. R. 1b–6b). Petitioner also now concedes that it must use the lower of cost or market method of inventory accounting for all years after 1959 (Pet. 6, 5a). The sole issue presented by this case is whether, as the lower courts held, petitioner must use this concededly correct method of accounting for its inventories for the years 1954 through 1956 as well as for subsequent years.

The Commissioner first questioned petitioner's method of inventorying used trailers at $1 each in 1948 with respect to tax years beginning in 1942. However, the Commissioner recognized that if he required petitioner to change to a correct method of inventorying used trailers, petitioner would get an unwarranted double deduction for more than $500,000 (R. 108a–111a). Under the case law, if the Commissioner required a taxpayer to change his inventory valuation method, the taxpayer was entitled to value his opening inventory in the year of the change according to the new method. If, as in this case, the change resulted in a large increase in the taxpayer's

[2] The Regulations specifically prohibit "Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value." Treas. Regs. (1954 Code), § 1.471–2(f)(2). The substance of this provision has been part of the Regulations since 1919. See Treas. Regs. 45, Art. 1582 (1919 ed.).

inventory, he would get a second deduction for costs which he had already deducted.[3] Because the Commissioner did not wish to give petitioner a second deduction for the more than $500,000 it had already improperly deducted, the Commissioner in 1950 decided to permit petitioner to continue using its erroneous method of inventorying used trailers at $1 each (R. 111a–112a).

On its returns for 1954 through 1956, the tax years here in question, the taxpayer continued to employ the $1 per unit inventory method. In 1959 the Commissioner notified the taxpayer that beginning with used trailers acquired after the close of 1953, and for all taxable years still open, it was required to use the lower of cost or market method. The Tax Court, in a reviewed opinion (two judges dissenting without opinion), held that petitioner's method of valuing its inventory of used trailers at $1 each was incorrect, that the Commissioner was not estopped from requiring petitioner to change to the lower of cost or market method, and that the Commissioner could properly

[3] For example, assume that in 1947 the taxpayer acquired 100 units at a cost of $10 each (*i.e.*, $1,000) and that at the end of 1947 he had all 100 units on hand. If he improperly inventoried the items at a nominal cost of $1 each, he would take a current deduction in 1947 of $900 (100 units x $9) and defer the deduction for the remaining $100—*i.e.*, the amount included in inventory (100 units x $1). If the Commissioner in 1948 required him to switch to a proper cost method of valuing inventory, the taxpayer would be entitled to increase his opening 1948 inventory from $100 (100 units x $1) to $1,000 (100 units x $10). Thus, when the taxpayer sold these 100 units he would get a second deduction for the $900 he had already deducted in 1947 at the time of acquisition.

make the change for all open years, including 1954 through 1956. However, the Tax Court also held that because the Commissioner had initiated the change in accounting method, the taxpayer was entitled to use the new method to compute its 1954 opening inventory even though this resulted in an inventory increase—and thus a double deduction—of more than $2,500,000.[4] (R. 125a–138a.)

In the court of appeals, petitioner conceded that the Commissioner could require the change and contended only that he could not make it retroactive to 1954 (Pet. 6; Pet. 5a). The Commissioner did not appeal from that part of the decision which gave petitioner a double deduction of more than $2,500,000. The court of appeals affirmed (Pet. 5a–8a).

The decision below is correct, and there is no conflict between the circuits or other basis for review by this Court. Indeed, far from contravening "the intendment and rationale" of decisions of this Court or conflicting with decisions of the courts of appeals, as the petitioner asserts (Pet. 6), the decision below is in complete accord with the decided cases.

1. Petitioner's sole contention in the court below—which was properly rejected—was that the Commissioner's acquiescence in 1950 in its erroneous method of valuing its used trailer inventory constituted a "legislative" determination which could not be "retroactively" changed in 1959 so as to require peti-

[4] The reason for this double deduction is the same as that explained *supra*, in fn. 3, p. 3. The Tax Court held that 1954 Code § 481 had not changed the previous case law on this point (R. 135a–138a).

tioner to use a correct method for the open years 1954–1956 (Pet. 5a–8a). In its petition for certiorari petitioner has apparently abandoned that position, and now contends "that the Commissioner does not have power to reverse retroactively a ruling that does not constitute a mistake of law," that the correctness of a particular method of accounting involves a question of "fact" rather than of "law", that the Commissioner thus did not commit a "mistake of law" when in 1950 he permitted petitioner to continue using its erroneous method of inventory accounting, and that consequently the Commissioner was precluded from requiring petitioner in 1959 to change to a correct method for 1954–1956 (Pet. 6–7, 14–15). Since these contentions were not raised below, they are not properly before the Court. Cf. *Burnet* v. *Commonwealth Improvement Co.*, 287 U.S. 415, 418; *Helvering* v. *Wood*, 309 U.S. 344, 349; *McCullough* v. *Kammerer Corp.*, 323 U.S. 327; *Duignan* v. *United States*, 274 U.S. 195, 200.

2. In any event, petitioner's contention is without substance. Petitioner concedes (Pet. 15–18), as it must, that the Commissioner has broad discretionary authority to permit or require a taxpayer to use a method of accounting which clearly reflects income. 1954 Code §§ 446, 471, 481, 7805; Treas. Regs. (1954 Code), §§ 1.446–1, 1.471–2; *United States* v. *Catto*, 384 U.S. 102, 114; *Schlude* v. *Commissioner*, 372 U.S. 128, 133–135; *Commissioner* v. *Hansen*, 360 U.S. 446; *Brown* v. *Helvering*, 291 U.S. 193, 204–205; *Lucas* v.

American Code Co., 280 U.S. 445, 449. The Commissioner's broad power to permit or require a change in a particular accounting method does not, as petitioner assumes, depend on whether the propriety of the method is characterized as a question of law or of fact. Rather, it turns on whether the method "clearly reflect[s] income." 1954 Code, §§ 446(b), 471. Moreover, it is well established that the Commissioner generally has the right to correct mistakes in a taxpayer's return for all past years which are not yet barred by the statute of limitations, even if the correction is a change of position on the Commissioner's part. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 183–186; *Burnet* v. *Porter*, 283 U.S. 230; *Dixon* v. *United States*, 381 U.S. 68; *McIlhenny* v. *Commissioner*, 39 F. 2d 356 (C.A. 3). Here petitioner has conceded that the lower courts were correct in holding that its method of valuing inventories at a nominal amount ($1 per item) specifically violated the Regulations and failed clearly to reflect its income. Therefore, unless the Commissioner is for some reason estopped, the normal rule would permit him to correct petitioner's erroneous method of inventory valuation for all open years, including 1954–1956.

In 1950 the Commissioner declined to require petitioner to change from its improper method of valuing used trailers at $1 to the proper lower of cost or market method, because any such change initiated by the Commissioner would have allowed petitioner to obtain a double deduction for more than $500,000 in expenses it had already deducted. However, it is

quite clear, as the Tax Court found, that the Commissioner never "forced petitioner to inventory its used trailers at $1 each," but that the Commissioner, anxious to avoid giving petitioner an unwarranted deduction of more than $500,000, merely "yielded to petitioner's wishes in this regard" and declined to require petitioner to make the change (R. 120a–121a). It is equally clear that petitioner could at all times itself have initiated a change to the lower of cost or market method and that the Commissioner would have consented to such a change if petitioner would have agreed to a reasonable settlement of the double deduction problem (R. 110a–112a). Thus the Commissioner never approved or misled petitioner into believing that he had approved its erroneous inventory method. The Commissioner merely declined to initiate a change because of the cost to the revenue.

Moreover, as the Tax Court found, petitioner did not suffer any detriment because the Commissioner waited until the tax year 1954 to require petitioner to adopt a correct method of inventory valuation. Every year that petitioner used its incorrect method large amounts of income were "deferred to later years," thus allowing petitioner instead of the government to use millions of dollars that would have been paid as tax (R. 121a). Additionally, the amount of petitioner's unwarranted double deduction increased from approximately $500,000 to more than $2,500,000 because the Commissioner required it to switch to a proper method of accounting as of 1954 instead of 1942.

3. Contrary to petitioner's contention (Pet. 9–10), there is no conflict with *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225 (C.A. 3), certiorari denied, 368 U.S. 898, and *American Can Co.* v. *Commissioner*, 317 F. 2d 604 (C.A. 2), certiorari denied, 375 U.S. 993. In those cases, taxpayers attempted to change from an erroneous method of accounting to a correct one but would not agree to adjustments. The Commissioner, in accordance with the Regulations,[5] refused to agree to the change and the courts of appeals sustained the Commission's action even though the result was to leave the taxpayers on erroneous methods of accounting. The instant case is concerned with the Commissioner's power to require a taxpayer to change from an incorrect to a correct method of accounting, while the cited cases dealt with the Commissioner's power to deny the taxpayer's request for permission to change from an incorrect to a correct method of accounting where the taxpayer refused to agree to adjustments which were necessary to prevent distortion of income. The portion of the opinion in *John Wanamaker Philadelphia, Inc.* v. *United States*, 359 F. 2d 437, 442 (Ct. Cl.), on which the taxpayer relies (Pet. 11–12), reaffirms these principles.[6]

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[5] Treas. Regs. 111 (1939 Code) § 29.41–2; now 1954 Code, § 446(e); Treas. Regs. (1954 Code) § 1.446–1(e).

[6] The petition invites the Court to grant review in order to decide (Pet. 17) "whether the Commissioner's discretion is broad enough to permit him to require a taxpayer to continue the use of a particular accounting method, where such method is erroneous, in order to prevent a distortion of income which would result in a tax detriment to the Government." This question, which was presented in cases such as *O. Liquidating*

Nor is there any conflict with *In re Sperling's Estate,* 341 F. 2d 201 (C.A. 2), certiorari denied, 382 U.S. 827. The taxpayer there erroneously filed his returns on the cash method of accounting, and the Commissioner without recomputing his income on the accrual method, asserted a deficiency. Taxpayer contended that the Commissioner could not assert a deficiency unless he recomputed taxpayer's income on the accrual method, although taxpayer's books and records did not disclose sufficient information to enable the Commissioner to accomplish this task. The Second Circuit held that the Commissioner did not abuse his discretionary authority in concluding that, while the taxpayer's cash method of accounting was improper, it would nevertheless (in light of the lack of records) give the best available picture of his income. In the instant case, the Commissioner has not concluded that the $1 per unit method of valuing inventory would best reflect the taxpayer's income.

The instant decision does not conflict with *Dobson* v. *Commissioner,* 320 U.S. 489. The statute then in effect limited review of Tax Court decisions to questions of law. The question there was whether the Tax

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and *American Can,* is not involved in the instant case. The question properly arises in those cases where the taxpayer initiates a change and the Commissioner, acting under Section 446(e) and the pertinent regulation, withholds his consent to the change pending settlement of adjustments. Moreover, the circuits considering the question are in full agreement that the Commissioner has discretion to withhold approval. See *Commissioner* v. *O. Liquidating Corp., supra; Wright Contracting Co.* v. *Commissioner,* 316 F. 2d 249 (C. A. 5), certiorari denied, 375 U.S. 879; *American Can Co.* v. *Commissioner, supra;* See, also, *Hackensack Water Co.* v. *United States,* 352 F. 2d 807 (Ct. Cl.).

Court's application of the tax benefit rule to the facts of that case raised a reviewable question of law. The Court held that only a question of fact was involved. The Court stated, however, that it is (320 U.S. at 492–493) "a clearcut question of law" where "applicable statutes and regulations properly interpreted forbid" a method of calculation. Here the Regulations expressly forbid the $1 per unit method. Moreover, the restricted definition of questions of law adopted in that case probably has little present vitality since the scope of review of Tax Court decisions is now the same as for district court cases. 1954 Code, § 7482.

Arizona Grocery v. *Atchison Ry.*, 284 U.S. 370, upon which petitioner also relies (Pet. 7–8), did not present any question of tax accounting. It involved a general order of the Interstate Commerce Commission fixing freight rates for railways operating between certain points, pursuant to a statute giving it power to fix rates, and as the court below observed (Pet. 6a) it "is not analogous to the case before us".

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1966.

U.S. GOVERNMENT PRINTING OFFICE: 1966

Office-Supreme Court, U.S.
FILED
SEP 1 1966
JOHN F. DAVIS, CLERK

No. 196

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

FRUEHAUF CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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PETITIONER'S REPLY BRIEF

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 196

FRUEHAUF CORPORATION, *Petitioner*

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PETITIONER'S REPLY BRIEF

I

The respondent's description of the Commissioner's 1950 action as a decision "to permit petitioner to continue using" the $1 per unit method of inventorying used trailers (p. 3), or as a mere "acquiescence" in the use of such method (p. 4), or as merely yielding to petitioner's wishes (p. 7), would convey the impres-

sion that the Commissioner's action was a mere passive acceptance of the $1 per unit method. The facts of record are to the contrary. Almost two years prior to 1950 the petitioner and the Internal Revenue authorities in Detroit had reached a tentative agreement under which petitioner's used trailer inventories were changed to the lower of cost or market value method; and in accordance with that tentative settlement petitioner (1) changed its books of account to reflect used trailer inventory on the lower of cost or market value method, (2) filed a claim for refund for 1946, (3) filed an amended return for 1947, and (4) filed its original 1948 return, all based on the use of the lower of cost or market value method of inventorying used trailers (R. 104a, 106a, 113a, 114a). The decision which the Commissioner made in 1950 was to reverse the 1948 tentative settlement, and thus recompute petitioner's income taxes for the years 1942-1945 on the $1 per unit method. As a consequence, and in furtherance of that decision to require the continued use of the $1 per unit method, the 1946 claim for refund and the 1947 amended return were rejected, and the 1948 return was recomputed by the Commissioner by inventorying used trailers on the $1 per unit method. Suffice it to say that these facts demonstrate that the Commissioner's 1950 decision constituted a positive action and not mere passive acquiescence.

II

Respondent argues that petitioner has abandoned the position raised below and has now put forth a new contention. His memorandum in opposition states (pp. 4 and 5) that petitioner's sole contention in the court below was that the Commissioner's "acquiescence" in

1950 in the $1 per unit inventory method constituted a "legislative" determination which could not be retroactively changed in 1959, but that petitioner now contends that the Commissioner's 1950 decision was not a mistake of law and hence cannot be reversed retroactively.

The position which the petitioner takes in this Court is precisely the same as that which it took in the Court of Appeals. That position may be summarized as follows: Congress, in enacting Section 41 of the Internal Revenue Code of 1939, delegated to the Commissioner of Internal Revenue broad discretion in the accounting field, i.e., he was empowered to compute a taxpayer's net income "in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." The authority thus delegated was something quite different from the authority to interpret the meaning of a particular statutory provision,—it endowed the Commissioner with a very wide discretion. Some courts and some text writers have labeled determinations or decisions taken under these two different powers as "legislative" and "interpretative," respectively. For example, in *Gibson Wine Co.* v. *Snyder*, 194 F. 2d 329, 331 (C.A.D.C. 1951) the Court said:

> "The distinctive characteristics of interpretative rulings, as contrasted with so-called regulations, have long been recognized. Administrative officials frequently announce their views as to the meaning of statutes or regulations. Generally speaking, it seems to be established that 'regulations', 'substantative rules' or 'legislative rules' are those which create law, usually implementary to an existing law; whereas interpretative rules are statements as to what the administrative officer thinks the statute or regulation means."

If the Commissioner makes a determination which erroneously interprets a statutory provision (an "interpretative" determination), such determination may be reversed retroactively, because it constitutes a mistake of law. But if the Commissioner makes a determination in an area where he is given a broad discretion, (a "legislative" determination), as in the accounting method area, such determination cannot be erroneous (unless it is an abuse of discretion). The position which petitioner took in the Court of Appeals was that the 1950 determination of the Commissioner requiring it to remain on the $1 per unit method was not a mistake of law and could not be reversed retroactively. This is the same position which petitioner takes here.

III

The respondent states (p. 6 of his memorandum) that "the Commissioner generally has the right to correct mistakes in a taxpayer's return for all past years which are not barred by the statute of limitations, even if the correction is a change of position on the Commissioner's part." This statement is valid enough as a general rule. The Commissioner may correct a decision which he has made with respect to a particular taxpayer in a particular year so long as the statute of limitations with respect to that year remains open, for until the statute expires any decision of the Commissioner remains tentative in character, *Burnet* v. *Porter*, 283 U.S. 230, and *McIlhenny* v. *Commissioner*, 39 F. 2d 356 (3d Cir. 1930), cited by respondent. This situation is not involved here. The Commission also may correct a mistake in a taxpayer's return for a year which is not barred by the statute of limitations, even though his ac-

tion is contrary to a determination made by him in an earlier year with respect to which the statute has run, if that earlier determination constituted a mistake of law. *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180 and *Dixon* v. *United States,* 381 U.S. 68. But where the decision in the earlier year does not constitute a mistake of law, it may not later be reversed retroactively. *Woodworth* v. *Kales,* 26 F. 2d 178 (6th Cir. 1928), *H.S.D. Co.* v. *Kavanagh,* 191 F. 2d 831 (6th Cir. 1951).

IV

The respondent has failed to come to grips with the question that constitutes the crux of this case—Did the Commissioner act within his statutory discretion in requiring, in 1950, that petitioner remain on the $1 per unit method of inventorying used trailers? In fact, respondent appears to have studiously avoided either affirming or denying that, as petitioner contends, the Commissioner was acting within the limits of his discretion in requiring petitioner to remain on the $1 method, in order to protect the revenue, even though he found such method to be "obviously erroneous." (R. 109a). If he was acting within his authority, his exercise of discretion was not a mistake of law and may not be reversed retroactively.

The language of Section 41, Internal Revenue Code of 1939, required the Commissioner, whenever he found that a taxpayer's method of accounting did not clearly reflect income, to compute net income "in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." His duty to see to it that income was clearly reflected, even to the extent of requiring a taxpayer to remain on an erroneous

method of accounting to protect the revenue, did not, as respondent suggests in footnote 6 on pages 8 and 9 of his memorandum, depend upon whether the taxpayer did or did not request permission to change his method. If the exercise of this duty by the Commissioner was subject to a higher duty, to protect the revenue, in cases where a change in method was requested by a taxpayer, then surely the paramount duty to protect the revenue fully justified the Commissioner in requiring the petitioner to remain on an erroneous method of accounting.

The determination made by the Commissioner in 1950 required the petitioner to remain on the $1 per unit method and to continue using such inventory method unless the petitioner requested and obtained permission to change. (Regulations 111, Section 29.41-2). The petitioner never requested permission to change, and there is no requirement in the Internal Revenue Code which obligated it to initiate a change in any method of accounting under such circumstances. Accordingly, the petitioner was required to continue to use the $1 per unit method, even though it was an erroneous method, until it was notified by the Commissioner of his intent to change such method to a correct method for future years.

If, as petitioner contends, the Commissioner was acting within the scope of his discretion in requiring, in 1950, that petitioner remain on the $1 per unit method of inventorying used trailers, such action was within the power given him by statute, and hence could not have been a mistake of law. If it was not a mistake of law, the Commissioner's 1950 determination may not be reversed in 1959 retroactively to 1954.

The important question here is: Did the Commissioner act within his discretion? The decisions of the Second Circuit in *American Can Co.* v. *Commissioner*, 317 F. 2d 604 (1963), and *In re Sperling's Estate*, 341 F. 2d 201 (1965), of the Third Circuit in *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225 (1961), and of the Court of Claims in *John Wanamaker Philadelphia, Inc.* v. *United States*, 359 F. 2d 437 (1966), require an affirmative answer, contrary to the decision of the Court of Appeals for the Sixth Circuit in the instant case, and we submit that this question should be finally determined by this Court

Respectfully submitted,

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